# Budget Deficits: An Explanation of How Policy Affects Budget Balance

March 16, 2009

Congressional Research Service
https://crsreports.congress.gov
R40435

CRS REPORT
Prepared for Members and
Committees of Congress

# Summary

In fiscal year (FY) 2008, the nation's budget deficit reached $455 billion or 3.2% of gross domestic product (GDP), up from $161 billion or 1.2% of GDP in FY2007. New deficit projections provide a picture of what the United States faces over the next decade. In February 2009, the Congressional Budget Office (CBO) projected that the deficit in FY2009 will reach more than $1.4 trillion. Between FY2010 and FY2019, cumulative deficits could reach as high as $10 trillion. CBO projects deficits in each fiscal year of this period. These deficits are largely a result of enacted federal financial intervention and fiscal stimulus legislation designed to alleviate the credit crunch and to bolster the economy. Current economic conditions have also led to increases in outlays for certain government social programs and declines in revenue collection, leading to further deterioration in the budget balance.

Several significant federal financial interventions were enacted in 2008 in an effort to relieve the credit crisis and mitigate the economic effects of the recession on Americans. These include the enactment of economic stimulus in early 2008, the Housing and Economic Recovery Act in July 2008, the Troubled Assets Relief Program (TARP) and its components in October 2008, the extension of unemployment benefits in November 2008, and the American Recovery and Reinvestment Act (ARRA) in February 2009. Other actions have involved the purchase of assets largely utilizing existing or expanded authority.

Deficits can serve as a powerful instrument of fiscal policy and are not necessarily problematic. Governments use deficit spending to smooth outlays and taxes so that taxpayers and program beneficiaries are shielded from abrupt economic shocks and to mitigate the size of those shocks. However, persistent deficits lead to growing accumulations of federal debt that may lead to higher interest payments, tax increases, or spending cuts.

Over time, deviations from baseline deficit projections can be attributed to three broad causes: legislative, economic, and technical changes. Projected fiscal balances can differ significantly from actual outcomes. Changes in legislative policy between January 2008 and January 2009 are likely to more than double the FY2009 deficit according to revisions to the CBO baseline over that period. Further, technical changes, largely attributed to the government placing Fannie Mae and Freddie Mac into conservatorship, will add hundreds of billions of dollars to the FY2009 deficit. Other factors will also contribute to a larger deficit in FY2009.

In his budget proposal, President Obama also outlined specific policies he hopes to implement, which include significant new agendas with regard to energy, health care, and education. If all of these provisions are enacted, the President's budget proposal would result in a FY2009 deficit of $1.752 trillion or 12.3% of GDP.

When the economy recovers from the current downturn, Congress may choose to focus more effort on balancing the budget and reining in debt by spending less, increasing taxes, or a combination of these things. Over the long-term, balancing the budget is further complicated by significant issues regarding entitlement spending, especially as it relates to rising health care costs. CBO has concluded that "under any plausible scenario, the federal budget is on an unsustainable path."

# Contents



## Tables



## Appendixes



## Contacts

The nation's budget situation is challenging. In fiscal year (FY) 2008, the budget deficit reached $455 billion or 3.2% of gross domestic product (GDP), up from $161 billion or 1.2% of GDP in FY2007. New deficit projections provide a picture of what the United States faces over the next decade. In February 2009, the Congressional Budget Office (CBO) projected that the deficit in FY2009 will reach more than $1.4 trillion, which includes the deficit impact of the American Recovery and Reinvestment Act (ARRA; H.R. 1, P.L. 111-5). Between FY2010 and FY2019, cumulative deficits could reach as high as $10 trillion. CBO projects deficits in each fiscal year of this period.[1]

These deficits are largely a result of federal financial intervention and fiscal stimulus legislation designed to alleviate the credit crunch and to bolster the economy. Current economic conditions have also led to increases in outlays for certain government social programs and declines in revenue collections, leading to further deterioration in the budget balance.

Economists generally agree that when an economy is in recession, running deficits by increasing government spending or cutting taxes can stimulate growth. However, once growth returns, they advise paying down debt. Though the economy is currently in recession and running deficits may be appropriate, the accumulated deficits will increase federal debt held by the public and will generally increase the portion of the budget devoted to future interest payments. Larger deficits today and in the future would add additional pressure to the long-term budget outlook, hampering the ability of Congress and the President to address other priorities like healthcare and entitlement reform.

This report will define deficits and will explain the appropriate way to measure them. It will also describe how current economic conditions and federal financial interventions have increased the deficit over time.

# What are Deficits?

Deficits can serve as a powerful instrument of fiscal policy. Differences between revenues and outlays determine whether or not the budget is in surplus or deficit, which often serves as a measure of the federal government's fiscal health. Annual budget deficits or surpluses determine, over time, the level of federal debt and affect the amount of annual interest paid to finance the debt. Occasional deficits, in and of themselves, are not necessarily problematic. Deficit spending allows governments to smooth outlays and taxes to shield taxpayers and program beneficiaries from abrupt economic shocks. Persistent deficits, on the other hand, lead to growing accumulations of federal debt that may lead to higher interest payments, tax increases, or spending cuts.

Changes in economic conditions can cause movements in outlays (spending) or revenues and can lead to changes in the budgetary outlook. These can occur simultaneously or as a result of each other. Economic growth can stimulate employment and individual income, generally reducing certain types of spending and increasing revenue levels. During a recession reductions in consumption and increased reliance on government programs have the opposite effect. For example, in a strong economy, new jobs are often created. If the unemployed become employed and earn higher incomes, additional tax revenue would be generated. In contrast, in a weak economy, people may lose their jobs, which could lower tax revenue and increase government expenditures on programs such as unemployment insurance and food stamps. Economists refer to

[1] U.S. Congress, Congressional Budget Office, *Estimated Impact on the Deficit of Three Alternative Policy Scenarios Specified by Speaker Pelosi and Chairman Spratt*, February 23, 2009.

these changes as automatic stabilizers.[2] Policy changes by the federal government to change spending or revenue levels (i.e., through the creation of new programs or through tax cuts) would also affect the size of the deficit.

The dollar value of the budget deficit (or surplus), however, may give a partial and potentially misleading picture of the government's true fiscal condition. Deficits and debt levels are often measured as a percentage of GDP, rather than in dollar amounts. Measurement of deficits and debt as a percentage of GDP provides adjustments for inflation and relates the size of the deficit or debt to the size of the economy.

## Understanding Deficit Projections in the CBO Baseline

The CBO baseline is an estimate of federal spending and receipts and resulting levels of surplus or deficit during a fiscal year, under existing law. Congress set forth specific rules for calculating direct spending, receipts, and discretionary spending baselines in Section 257 of the Balanced Budget and Emergency Deficit Control Act of 1985 (Title II of P.L. 99-177), as amended.[3] A baseline provides a benchmark for comparing proposed budget policy changes to existing policies and indicating changes that may be necessary to meet certain budgetary goals. Therefore, the calculation of a baseline can be instrumental to the evaluation of budget policies.

However, there are numerous uncertainties surrounding the baseline projections, especially in the out-years, and they cannot be thought of as absolute certainty of the government's fiscal condition. According to CBO, "[t]he baseline is intended to provide a neutral, nonjudgmental foundation for assessing policy options. It is not 'realistic,' because tax and spending policies will change over time. Neither is it intended to be a forecast of future budgetary outcomes."[4] The proper way to use a baseline is as a rule-of-thumb estimate for the budgetary ramifications of current policy. This offers the policymaker a means to measure the relative effects of proposed legislation in the context of the overall budget.[5]

# Current Conditions

The deficit in FY2008 was $455 billion, or 3.2% of GDP, sharply higher than the FY2007 deficit of $162 billion (1.2% of GDP). In January 2009, CBO projected that the deficit would reach nearly $1.2 trillion (8.3% of GDP) in FY2009, which did not include the effects of the American Recovery and Reinvestment Act of 2009 (ARRA).[6] At the request of Speaker of the House Nancy Pelosi and House Budget Committee Chairman Spratt, CBO released three alternative budget scenarios in February 2009. Under all of the scenarios, CBO projected a deficit of $1.4 trillion in FY2009, with the majority of the deficit increase from the January to February projections

---

[2] See CRS Report RL31235, *The Economics of the Federal Budget Deficit*, by Brian W. Cashell.

[3] Until the expiration of this section at the end of FY2006, CBO was required to follow the provisions of Section 257 in producing its baseline projections. CBO has indicated that it will follow these practices until directed otherwise by Congress. For more information, see CRS Report 98-560, *Baselines and Scorekeeping in the Federal Budget Process*, by Bill Heniff Jr.

[4] U.S. Congress, Congressional Budget Office, *The Budget and Economic Outlook*: *Fiscal Years 2002-2012*, January 2001, p. 7.

[5] For more information, see CRS Report RL31414, *Baseline Budget Projections: A Discussion of Issues*, by Marc Labonte.

[6] These estimates are based on current law under a specific set of assumptions. As will be discussed later, changes in policy or use of different assumptions would change these estimates. U.S. Congress, Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2009 to 2019*, January 2009.

occurring as a result of ARRA.[7] CBO also projected the continuation of deficits well into the future. This budgetary outlook is largely attributed to the effects of the economy as well as the significant federal financial interventions and stimulus legislation already passed by Congress. Additional actions may increase the deficit further.

CBO also projects that the recession, probably the longest and deepest since World War II (WWII), will likely last well into 2009.[8] The current condition of the economy will likely result in increases in outlays for mandatory programs, such as food stamps and unemployment benefits, also known as "automatic stabilizers," and increases in the deficit. Revenue collection is also projected to be lower largely due to declines in personal incomes and corporate profits. The deficit impact of these increases in outlays and decreases in revenues is accounted for in the CBO baseline.

The projected deficit for FY2009 is high relative to historic standards. The deficit reached its peak in 1943 at 30.3% of GDP. After WWII, deficits remained relatively low until the mid-1980s. In FY1985, the deficit reached 6.0% of GDP.[9] If the deficit in FY2009 reaches the projected level, it will likely be the highest deficit as a percentage of GDP since FY1946.

## Recent Policies and Their Effects on the Deficit

Several significant federal financial interventions were enacted in 2008 and early 2009 in an effort to relieve the credit crisis and mitigate the economic affects of the recession on Americans. These include the enactment of economic stimulus in early 2008, the Housing and Economic Recovery Act (HERA) in July 2008, the Troubled Assets Relief Program (TARP) and its components in October 2008, the extension of unemployment benefits in November 2008, and the American Recovery and Reinvestment Act (ARRA) in February 2009. Other actions, such as interventions by the Federal Reserve (Fed) and the Federal Deposit Insurance Corporation (FDIC), have largely utilized existing or expanded authority. The long-term impact of these programs on the budget deficit is somewhat uncertain.

The size, variety, and complexity of federal responses to financial and economic turmoil present many challenges to budget analysis. The ultimate costs of these responses will depend on how the economy recovers, how well firms receiving federal assistance weather future financial shocks, and whether or not the government receives positive returns on its asset purchases. Estimating how much these responses will cost the federal government is difficult, both for conceptual and operational reasons.[10]

### Economic Stimulus Act of 2008

In February 2008, Congress enacted the Economic Stimulus Act of 2008 (P.L. 110-185) aimed at promoting consumption and investment by sending rebates to taxpayers and allowing firms to

---

[7] U.S. Congress, Congressional Budget Office, *Estimated Impact on the Deficit of Three Alternative Policy Scenarios Specified by Speaker Pelosi and Chairman Spratt*, February 23, 2009.

[8] *Ibid*.

[9] For more information about historical movements in federal debt and deficit levels, see CRS Report RL34712, *Ebbs and Flows of Federal Debt*, by Mindy R. Levit.

[10] For more information, see CRS Report R40088, *The Federal Budget: Current and Upcoming Issues*, by Mindy R. Levit and D. Andrew Austin.

depreciate new capital investments more quickly. The costs of these provisions increased the deficit by $152 billion in FY2008 and by an estimated $16 billion in FY2009.[11]

## Housing and Economic Recovery

The Housing and Economic Recovery Act (HERA, P.L. 110-289) provided new authority to address issues in the mortgage markets by allowing banks to write down the balance of existing loans so that borrowers can refinance and avoid foreclosure. The act also contained other provisions to help local communities acquire and redevelop vacant and foreclosed properties and created a new regulator for the government-sponsored enterprises (GSEs), Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. The act gave Treasury the temporary authority to purchase debt and equity securities of the GSEs.[12] The provisions of HERA increased the deficit by $1.4 billion in FY2008 and are expected to increase the deficit by $36.7 billion in FY2009 and $3.6 billion in FY2010.[13]

CBO's deficit estimate for FY2009 includes the addition of Fannie Mae and Freddie Mac, previously not accounted for in the budget. They have been included by CBO in their budget baseline because they were placed under direct control of the federal government on September 6, 2008. This action added $238 billion to the deficit in FY2009, an amount which represents CBO's estimate of the net present value of the current outstanding obligations and securities of the GSEs. These transactions are being recorded by CBO on a net present value basis rather than a cash basis. The net present value reflects the asset purchase price, less the present value of future asset income, plus an adjustment for market risk.[14] In subsequent years, the effect on the budget is projected to be much smaller, $66 billion between FY2010 and FY2019, because the subsidy cost would only relate to the net present value of new business. Even if Fannie Mae and Freddie Mac are excluded from the FY2009 deficit calculation, the FY2009 deficit would still reach a post-WWII high.[15]

### *Troubled Assets Relief Program*

On October 3, Congress passed the Emergency Economic Stabilization Act of 2008 (EESA; P.L. 110-343), which, among other provisions, authorized the Treasury Secretary to use $700 billion (subject to certain Congressional restrictions and notifications) to intervene in financial markets. While former Treasury Secretary Henry Paulson first proposed using TARP funds to buy mortgage-related securities, those plans were later dropped. Instead, the Treasury Department used TARP funds to recapitalize banks and financial institutions by acquiring preferred shares. On November 12, Paulson announced that a portion of TARP would fund a new Federal Reserve collateralized lending program, the Term Asset-Backed Securities Loan Facility (TALF), which would take in securities based on "newly and recently originated" loans, such as for education, automobiles, and credit cards. In addition, TARP funds were also loaned to automakers and used

[11] Joint Committee on Taxation, Report Number JCX-17-08, available at http://www.house.gov/jct/x-17-08.pdf. Over the FY2010 to FY2018 period, some of the bonus depreciation costs will be recovered.

[12] For more information, see CRS Report RL34623, *Housing and Economic Recovery Act of 2008*, coordinated by N. Eric Weiss.

[13] U.S. Congress, Congressional Budget Office, Cost Estimate for H.R. 3221 Housing and Economic Recovery Act of 2008, available at http://www.cbo.gov/ftpdocs/95xx/doc9597/hr3221.pdf.

[14] Market risk is the cost resulting from the potential of future declines in the value of the asset due to market conditions.

[15] U.S. Congress, Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2009 to 2019*, January 2009.

to purchase equity in and guarantee assets of numerous financial institutions. As of December 31, 2008, the Treasury Secretary had disbursed or committed $350 billion in TARP money. The release of the remaining $350 billion was made available after certification in January.[16]

CBO estimates a deficit increase as a result of TARP outlays of approximately $180 billion in FY2009 and $5 billion in FY2010. This amount differs from actual TARP outlays due to the 1990 Federal Credit Reform Act and due to provisions of EESA, which require these transactions to be recorded by CBO on a net present value basis with an adjustment for market risk rather than on a cash basis.[17] CBO projects a cost of $180 billion based on assumption of a 25% average subsidy rate for these purchases (i.e., the rate used to calculate the net present value).[18] If these asset purchases were accounted for in the budget estimates solely based on the purchase price, the estimated deficit would be substantially higher in the near term. These costs would be recovered for budgetary purposes when the assets are sold in the future, essentially creating negative outlays at that time. Though CBO estimates the budgetary impact to be much lower than the purchase price, the Treasury Department must still raise enough money by selling debt to make the purchases in the first place.

### *Extension of Unemployment Benefits*

On November 21, 2008, President Bush signed the Unemployment Compensation Extension Act of 2008 (P.L. 110-449) into law, which expanded the potential duration of unemployment benefits up to a maximum of an additional 20 weeks. It also created a second tier of benefits for workers in states with high unemployment of up to a maximum of an additional 13 weeks. This additional coverage helps those workers who have exhausted the traditional 26 week benefit period. CBO estimated the impact on the deficit of these provisions at $9 billion for FY2009.[19]

### *American Recovery and Reinvestment Act of 2009*

On February 17, 2009, President Obama signed the American Recovery and Reinvestment Act of 2009 (ARRA; H.R. 1, P.L. 111-5), which included $501 billion in new outlays and $286 billion in net tax cuts for a variety of activities in an attempt to stimulate the economy. Provisions include Medicaid funding assistance for states, funding for infrastructure projects, tax incentives for small businesses, and expanded tax credits for individuals and families.[20] CBO estimates that this economic stimulus legislation will increase the deficit by $185 billion in FY2009, $399 billion in FY2010, $134 billion in FY2011, and $787 billion over the FY2009 through FY2019 period.[21]

---

[16] The final $350 billion in authority was exercised upon transmission of a written report by the President detailing the plan for the exercise of this authority. Congress had 15 calendar days to pass a joint resolution under “fast track” rules, to deny the authority to use the final $350 billion. The second half of the TARP funds were released after the Senate failed to block the release (S.J.Res. 5), though the House subsequently voted to block their release (H.J.Res. 3).

[17] The Bush Administration recorded these amounts on a cash basis rather than a discounted present value basis, which reflects greater outlays in the current time period to be offset by future gains when the asset is sold. The Obama Administration may record these assets purchases differently.

[18] U.S. Congress, Congressional Budget Office, *The Troubled Asset Relief Program: Report on Transactions Through December 31, 2008*, January 2009.

[19] U.S. Congress, Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2009 to 2019*, January 2009, Table 8.

[20] For more information, see CRS Report R40104, *Economic Stimulus: Issues and Policies*, by Jane G. Gravelle, Thomas L. Hungerford, and Marc Labonte.

[21] U.S. Congress, Congressional Budget Office, *Cost Estimate for H.R. 1 Conference Agreement*, February 13, 2009, Table 1.

### Other Actions

The Federal Reserve (Fed) has also played a major role throughout the economic downturn in limiting systemic risk. Through its various programs, the Fed has provided direct financial assistance of $1 trillion to borrowers. Though the activities of the Fed do not directly impact the federal budget, its profits are remitted to Treasury and recorded as revenues in the budget. Over the longer term, these actions may alter the level of remittances to the Treasury, thereby increasing or decreasing federal revenues.

Unlike all other institutions, currency (Federal Reserve notes) is the Fed's primary liability. Along with its holdings of Treasury securities, its assets are the loans it makes and the private assets it holds. Its loans and asset purchases are financed by increasing its liabilities (Federal Reserve notes), and does not inherently impose any cost to the Treasury. Indeed, if the loans are repaid, they would increase the profits of the Fed, which in turn would increase the Fed's remittances to the Treasury.[22] Even if the loans are not repaid, they are fully collateralized (in some cases, over-collateralized), so the Fed would not suffer losses unless the collateral loses value. In addition, some of the loans are made with recourse, which means that the firms are liable if the collateral loses value.[23]

The Treasury Department has made large cash deposits at the Fed to try to offset some of the potential inflationary effects of the Fed's actions through a new program called the Treasury Supplementary Financing Program. To finance these deposits, the Treasury has significantly increased the national debt. According to CBO, the Treasury Supplementary Financing Program increased the national debt by $296 billion in 2008.[24] Eventually, it is expected that these funds will no longer be needed and the additional debt will be paid off. CBO projects that the additional debt will be paid off in 2009, although that is unlikely to occur until the Fed withdraws its emergency assistance to the financial sector, which has not occurred to date. This program is not counted toward the deficit since it does not affect government outlays or revenues; as a result, 2008 was a rare occasion when changes in the debt did not mirror the budget deficit.

The FDIC has also taken a number of actions aimed at supporting the housing and financial markets. These actions include a temporary increase to deposit insurance for individual accounts from $100,000 to $250,000, the creation of a Temporary Liquidity Guarantee Program (TLGP), and efforts to reduce foreclosures. The TLGP is intended to strengthen confidence and encourage liquidity in the banking system by guaranteeing newly issued senior unsecured debt of banks, thrifts, and certain bank holding companies. The FDIC has also sought buyers for distressed banks. However, since the FDIC has increased its guarantees to individuals and banks, the pressure on its deposit insurance fund has grown. If financial distress causes these guarantees to be called upon, the FDIC may require additional funds from the Treasury to meet FDIC obligations, thereby increasing the budget deficit.

## CBO's Baseline Deficit Projections

**Table 1** illustrates how the programs described above have and are expected to alter the deficit situation over the next 10 years. The legislation included in this table has been enacted since

---

[22] Assuming that the interest rate on the loans exceeded the rate of return on the Treasuries that the Fed would have purchased if the loans had not occurred.

[23] For more information on the Federal Reserve's financial intervention activities, see CRS Report RL34427, *Financial Turmoil: Federal Reserve Policy Responses*, by Marc Labonte.

[24] For more information, see CRS Report RL34427, *Financial Turmoil: Federal Reserve Policy Responses,* by Marc Labonte.

CBO's January 2008 baseline estimates. As **Table 1** shows, legislative activity will have the greatest impact on increasing the deficit in FY2009. As a result of the TARP legislation, the deficit is estimated to increase by $184 billion, on a net present value basis, in FY2009 and $5 billion between FY2010 and FY2018. In addition, ARRA will add $185 billion to the deficit in FY2009 and $603 billion between FY2010 and FY2018. In subsequent years, legislative, economic, and technical changes will contribute nearly the same amounts towards increasing the deficit. With the passage of the stimulus legislation, legislative changes will contribute even more to the increases in the deficit, particularly in FY2010 and FY2011.

The **Appendix** to this report details how the baseline changed from projected surpluses to deficits as a result of legislative policy and other conditions between January 2001 and January 2009.

**Table 1. Legislative, Economic, and Technical Changes to the CBO Baseline Deficit Projections Between January 2008 and January 2009**

(billions of dollars)

| | 2008 | 2009 | 2010-2018 |
|---|---|---|---|
| Baseline Budget Deficit (-)/ Surplus (+) Projection in Jan. 2008 | -219 | -198 | 472 |
| Total Legislative | -192 | -601 | -1,340 |
| ARRA | 0 | -185 | -603 |
| HERA[a] | -1 | -17 | 17 |
| TARP[b] | 0 | -184 | -5 |
| Other Discretionary Spending | -31 | -51 | -78 |
| Other Mandatory Spending | -45 | -37 | -62 |
| Revenue | -115 | -116 | 74 |
| Debt Service | 0 | -10 | -681 |
| Economic | -29 | -110 | -1,887 |
| Technical | -17 | -464 | -1,040 |
| GSEs | 0 | -238 | -66 |
| Projected Budget Surplus(+)/Deficit(-) | -455 | -1,372 | -3,795 |

**Source:** CRS calculations based on CBO data.

**Notes:** Years are fiscal years. Figures for 2008 are actual. Columns may not be additive due to rounding.

a. GSE costs are accounted for in technical changes.

b. The Administration estimates the net present value of TARP purchases at $247 billion for FY2009.

After legislative changes and the estimated effects of the economy are accounted for, the remaining difference between the original projection and actual result is classified as a technical change. These changes occur because CBO's projections of revenues and mandatory spending are also based on other technical assumptions unrelated to the state of the economy, creating differences between the actual results and original assumptions. For example, mandatory spending levels depend on actual program participation rates rather than the projected participation rates, which may be different. Similarly, tax revenues will depend not only on the growth in income, but how quickly tax liability rises as income rises and how income growth is distributed across taxpayers. Most technical changes tend to be on the revenue side rather than the spending side of the budget.

Technical changes in FY2009 largely stem from the decision to include the net present value of Fannie Mae and Freddie Mac's existing assets and liabilities, as discussed earlier. Second, economic conditions have led to downward revisions in revenue projections due to lower projections of nominal GDP and the components of taxable income. Some of these declines have been offset by lower interest payments on the federal debt due to lower interest rates on current borrowing. Over the longer term, the deficit estimates may change depending on the actual pace of economic recovery and whether or not additional legislation affecting outlays or revenues in response to the economic slowdown is enacted.

### Current Policies Not Included in the CBO Baseline

Under the baseline, deficits continue to fall over the next ten years. This pattern occurs due to the traditional practices employed by CBO with regard to baseline budget estimation and projection, which assume the continuation of current policy. Therefore, if certain tax or spending provisions are scheduled to expire (although widely expected to be extended), the costs of these provisions are not included in the CBO baseline. Their inclusion would likely lead to further increases in the deficit. Policies currently being excluded from the baseline but which some believe are likely to be continued in some form include extension of the alternative minimum tax "patch" to adjust for inflation, additional war financing costs, and increases in discretionary spending over and above the current baseline estimates. The baseline also assumes that the 2001 and 2003 Bush tax cuts will expire at the end of FY2010, resulting in an increase in revenues. According to President Obama's budget outline, he proposes to extend some of these tax cuts. Actual effects on spending and revenues as a result of these issues could vary depending on numerous factors.

## The Deficit in President Obama's Budget Outline

On February 25, 2009, President Obama released his budget proposal, which "accounts for items that under the old rules could have been left out ... " Below, **Table 2** illustrates how the costs accounted for under the Obama Administration's baseline budget will affect the deficit over the next ten years. Between FY2009 and FY2019, cumulative deficits are expected to reach over $10.7 trillion. The most costly provisions include extending the 2001 and 2003 tax cuts as well as including the full year cost of financing overseas operations. Previous budgets had assumed that the tax cuts would expire at the end of FY2010, which would result in revenue increases starting in FY2011 and did not include the costs of financing the wars in Iraq and Afghanistan, which were usually funded through annual supplemental appropriations. The Administration also includes a placeholder line item for an additional $250 billion in future financial market stabilization efforts.

**Table 2. Deficit Estimates Under President Obama's Current Policy Scenarios**

(billions of dollars)

| | 2009 | 2010-2019 |
|---|---|---|
| BEA Baseline Deficit (-)/ Surplus (+) Projection[a] | -1,212 | -1,614 |
| Index to Inflation the 2009 parameters of the AMT as enacted in ARRA | 0 | -576 |
| Extension of 2001 and 2003 Tax Cuts | 0 | -2,681 |
| ARRA | -202 | -591 |

| | 2009 | 2010-2019 |
|---|---|---|
| Adjustments to reflect costs of overseas contingency operations and disasters | -81 | -1,496 |
| Placeholder for potential additional financial stabilization efforts | -250 | 0 |
| Other Adjustments[b] | -14 | -2,025 |
| Deficit under Current Policy Baseline | -1,759 | -8,983 |

**Source:** OMB

**Notes:** Columns may not be additive due to rounding.

a. Though CBO and the Administration use the provisions of the BEA to create their baseline estimates, economic or technical assumptions may cause slight differences in the baseline estimates from the two sources.

b. Includes debt service.

In his budget proposal, President Obama also outlined specific policies he hopes to implement, which include significant new agendas with regard to energy, health care, and education. If all of these provisions are enacted, the President's budget proposal would result in an FY2009 deficit of $1.8 trillion or 12.3% of GDP. Over the longer term, the Administration's proposal projects a deficit of $570 billion (3.1% of GDP) in FY2014 and $712 billion (3.1% of GDP) in FY2019.[25]

# Future Expectations

Deficits that exceed growth in the economy are not sustainable in the long-run. To eventually reduce the deficit would require less spending, increased taxes, faster than average economic growth, or a combination of these things. Over the long-term, entitlement spending, especially as it relates to rising health care costs, is projected to increase rapidly. The nation's aging population, combined with rising health care costs per beneficiary, seems likely to keep federal health costs rising faster than per capita GDP. CBO has concluded that "under any plausible scenario, the federal budget is on an unsustainable path," over the long run.[26] The Government Accountability Office and the Office of Management and Budget reach similar conclusions.

According to CBO projections, keeping future federal outlays at 20% of GDP, approximately its current share, and leaving fiscal policies unchanged would require drastic reductions in all spending other than that for Medicare, Social Security, and Medicaid. A former CBO Acting Director stated that, "by 2030 ... spending for those programs [Medicare, Social Security, and Medicaid] is projected to reach roughly 15 percent of GDP.... If that increase happened ..., the rest of the budget would have to be cut by more than half" to keep overall spending close to its current level. The Administration indicated similar concerns about the outlook for the budget over the long term in the President's FY2009 budget.

[25] Office of Management and Budget, *"A New Era of Responsibility: Renewing America's Promise,"* February 2009, Table S-1.

[26] U.S. Congress, Congressional Budget Office, *Long Term Budget Outlook*, December 2007, p. 1.

# Appendix. An Analysis of Deficit Movements over the Last Decade

In January 2001, CBO projected budget surpluses through FY2011, the entire 10-year projection window. However, in each fiscal year completed since that time, federal spending has accounted for approximately a fifth of the economy (as measured by gross domestic product—GDP) and federal revenues have ranged between just under a sixth and just over a fifth of GDP, resulting in budget deficits. **Table A-1** shows the differences between the 2001 baseline CBO projections and the actual budget balance between FY2001 and FY2008 by attributing the deficit increases to the legislative, economic, and technical categories.

In addition to the direct effect of new legislation on the budget, some determinants of spending and revenues are not directly controlled by Congress. As discussed earlier, changing economic conditions can affect spending and revenue levels through automatic stabilizers as well as shifting the size of the tax base.

After legislative changes and the estimated effects of the economy are accounted for, the remaining difference between the original projection and actual results is classified as a technical change. As explained previously, these changes occur because CBO's projections of revenues and mandatory spending are also based on other technical assumptions unrelated to the state of the economy, creating differences between the actual results and original assumptions. Some technical changes are the result of legislative changes. The cost of the legislative changes are ex ante projections of their cost (as scored by CBO and the Joint Committee on Taxation) made at the time the policy was enacted. If policies turned out to be more (less) expensive than the official score, this would appear in the table as a negative (positive) technical change.

**Table A-1. Differences Between 2001 Baseline Projections and the Actual Budget Balance, FY2001-FY2008**

(billions of dollars)

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|---|
| Baseline Surplus Projection in Jan. 2001 | 281 | 313 | 359 | 397 | 433 | 505 | 573 | 635 |
| Legislative Changes | -81 | -150 | -363 | -519 | -543 | -632 | -721 | -1005 |
| Revenue (Tax Cut) | -74 | -81 | -186 | -272 | -218 | -199 | -233 | -381 |

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|---|
| Non-Defense Discretionary Spending | 0 | -12 | -35 | -49 | -65 | -93 | -83 | -89 |
| Defense Spending | 0 | -38 | -84 | -122 | -155 | -177 | -205 | -245 |
| Mandatory Spending | -7 | -14 | -43 | -41 | -41 | -72 | -72 | -118 |
| Debt Service | 0 | -5 | -15 | -37 | -60 | -93 | -131 | -175 |
| Economic Changes | -37 | -121 | -113 | -59 | 2 | 15 | 20 | 1 |
| Technical Changes | -35 | -201 | -259 | -231 | -206 | -137 | -34 | -86 |
| Total Changes | -153 | -471 | -737 | -810 | -751 | -753 | -736 | -1090 |
| Actual Budget Surplus(+)/Deficit(-) | 128 | -158 | -378 | -413 | -319 | -248 | -163 | -455 |

**Source:** CBO, *Budget and Economic Outlook*, January 2002 to October 2008; *An Analysis of the President's Budgetary Proposals*, March 2002 to March 2007.

**Notes:** Years are fiscal years. Debt service refers to additional interest payments made on the national debt resulting from all legislative changes to revenues or outlays. Columns may not be additive due to rounding. In the January baseline, CBO does not report changes to the previous year budget deficit that occurred since the August baseline. Therefore, any changes between the actual deficit and the baseline deficit reported in August have been apportioned evenly between economic and technical changes.

CBO projected an FY2008 budget surplus of $635 billion under the policies in place in January 2001. The actual budget deficit was $455 billion, a difference of more than $1 trillion between the projection and the actual outcome. The FY2008 deficit marked the greatest difference to date between the surplus projections and the actual result.

## Deficit Responses to Legislative Changes

Legislative changes have resulted in lower revenues and increased spending because, as expected, policy has changed since CBO made its projection in 2001. Overall, legislative changes accounted for almost three-quarters of the cumulative shift from surplus to deficit over the past eight years. The legislative changes that increased the deficit the most were the tax cuts (the largest of which were P.L. 107-16 and P.L. 108-27), the increase in military and related spending in Iraq and Afghanistan, and the recent economic stimulus and recovery legislation (P.L. 110-185, P.L. 110-289, and P.L. 110-185).[27] Tax cuts accounted for nearly half of all legislative changes and military spending accounted for about 30%, with the remaining being caused by higher mandatory and non-military discretionary spending (including the 2008 stimulus) for the total increase in the deficit between 2001 and 2008.[28]

Comparing legislative changes to the baseline surplus projection made in 2001 demonstrates that, even if there had been no economic downturn or any other projection error, legislative changes alone would still have caused a budget deficit in each year from 2003 to 2008. The contribution of legislative changes to deficit has grown each year since 2001. Because economic and technical changes became smaller, the overall deficit declined between 2004 and 2007. The deficit rose in 2008 primarily due to legislative changes, which were responsible for 92% of the increase in the deficit in that year.

[27] The cost of revenue changes has declined since 2004 because of the expiration of certain tax provisions, most notably accelerated depreciation for corporate investment.

[28] Debt service is excluded from this calculation since the debt service shown in the table is the direct result of other legislative changes that increased government borrowing. (Debt service also increased because of economic and technical changes, but that is not broken out separately in the table.)

These legislative changes helped move federal revenues as a share of gross domestic product (GDP) from a 50-year high in 2000 to a 45-year low in 2004. The subsequent rise in revenues brought revenues slightly above the 50-year average share of GDP in 2007. Meanwhile, federal spending as a share of GDP rose from its lowest level in 35 years in 2000 to a level about equal to the 50-year average in 2004, where it remained in 2007. In 2008, as a share of GDP, revenues fell to their lowest levels since 2005, while spending reached its highest level since 1994. Legislation enacted in 2008, including TARP and investments in other economic recovery programs, are projected to cause increases in the deficit in future fiscal years.

Of course, an estimate of how much higher spending contributed to the shift to deficit depends on one's baseline definition of spending under current policy. Because discretionary spending is largely determined on an annual basis and not bound by previous year law, there is no obvious definition of current policy for discretionary spending. CBO's mandated definition of current policy is that discretionary spending grows at the same rate as inflation. Many analysts have criticized this definition as being too low because it would have consistently under-predicted spending historically. If a higher rate of spending growth (i.e., a rate equal to GDP growth) was assumed to represent current policy, then CBO's original estimates of future surpluses in 2001 would have been smaller, and higher spending would have subsequently accounted for a smaller proportion of the shift to deficit.

## Deficit Responses to Economic Conditions

Economic conditions also affected revenues and spending, contributing to changes in the deficit since CBO's 2001 projection through "automatic stabilizers," higher than expected inflation, and lower than expected interest rates. These are shown as economic changes in the table. The economic recession of 2001 was an important cause of the deficit in 2002 and 2003. Beginning in 2004, economic conditions had little effect on the shift to deficit. Towards the end of 2008, deteriorating economic conditions began affecting the deficit once again, however the full magnitude will likely be felt in later years. Between 2002 and 2008, economic changes accounted for about 4% of the shift to deficit.

## Deficit Responses to Technical Changes

Technical changes peaked as a cause of the shift to deficit at $259 billion in 2003, and have declined somewhat since then. For the last eight years overall, technical changes accounted for just over one-fifth of the shift from surplus to deficit. Large economic and technical changes point to the significant uncertainty behind budget projections, even over short periods of time. For example, holding policy constant, the 2001 surplus was $72 billion smaller ($37 billion due to economic changes, $35 billion due to technical changes) than CBO's projection made only nine months earlier.

Some technical changes are the result of legislative changes. There has been recent discussion of whether the 2007 deficit was smaller than anticipated because the tax cuts partly "paid for themselves" through higher economic growth, an effect that was not included in their original score. **Table A-1** suggests otherwise—although the 2007 deficit was smaller than anticipated in projections made in 2004 and 2005, when CBO was extremely pessimistic about future revenues, the deficit was much larger than anticipated in projections made before 2004. The 2001 projection of the state of the economy in 2007—made before the tax cuts were enacted—turned out to be extremely close to the actual state of the economy in 2007. In other words, the actual performance of the economy after the tax cuts was almost identical to how CBO expected the economy to perform had there been no tax cuts. For example, CBO projected in 2001 that economic growth (without tax cuts) would average 3.1% between 2003 and 2008 (on a fiscal year basis); actual growth in those years equaled 3.0%. Furthermore, there were extremely large technical revisions from 2002 to 2006, mostly because tax revenue turned out to be lower than expected (after taking the tax cuts into account) each year. If anything, this would suggest that tax cuts cost more in reality than the original score had anticipated, rather than less.[29]

## Author Information

Mindy R. Levit
Analyst in Public Finance

Marc Labonte
Specialist in Macroeconomic Policy

## Disclaimer

This document was prepared by the Congressional Research Service (CRS). CRS serves as nonpartisan shared staff to congressional committees and Members of Congress. It operates solely at the behest of and under the direction of Congress. Information in a CRS Report should not be relied upon for purposes other than public understanding of information that has been provided by CRS to Members of Congress in connection with CRS's institutional role. CRS Reports, as a work of the United States Government, are not subject to copyright protection in the United States. Any CRS Report may be reproduced and distributed in its entirety without permission from CRS. However, as a CRS Report may include copyrighted images or material from a third party, you may need to obtain the permission of the copyright holder if you wish to copy or otherwise use copyrighted material.

[29] See also CRS Report RL32502, *What Effects Did the 2001 to 2003 Tax Cuts Have on the Economy?*, by Marc Labonte; and CRS Report RL33672, *Revenue Feedback from the 2001-2004 Tax Cuts*, by Jane G. Gravelle.